

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

77-6005

IN THE
**United States Court of Appeals
FOR THE SECOND CIRCUIT**

Docket No. 77-6005

SECURITIES INVESTOR PROTECTION CORPORATION,
vs. *Applicant,*

EXECUTIVE SECURITIES CORPORATION,

Defendant.

SECURITIES AND EXCHANGE COMMISSION,
vs. *Plaintiff,*

EXECUTIVE SECURITIES CORPORATION, et al.,

Defendants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF APPELLEES

**Cameron F. MacRae, III, Trustee,
and the Securities Investor Protection Corporation**

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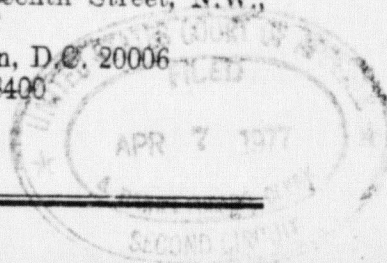


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and the Securities Investor Protection Corporation

Preliminary Statement

This is an appeal from the decision and order of the United States District Court for the Southern District of New York, by Charles H. Tenney, J., affirming the order of the Bankruptcy Court, by John J. Galgay, Bankruptcy

Judge, which denied Appellants status as "customers" under Section 6(c)(2)(A)(ii) of the Securities Investor Protection Act of 1970. The District Court's decision is reported at 423 F. Supp. 94.

Statement of Issue

Are Shearson Hayden Stone, Inc. and Yale University "customers" of Executive Securities Corporation within the meaning of the Securities Investor Protection Act of 1970 and therefore entitled to the preferential treatment afforded to "customers" thereunder, or are they instead general creditors of Executive?

Statement of Case

Summary of the Case

On February 14, 1975, the United States District Court for the Southern District of New York, by Judge Tenney, determined that the customers of Executive Securities Corporation ("Executive") were in need of protection under the Securities Investor Protection Act of 1970 (the "1970 Act")¹ and appointed Cameron F. MacRae III as Trustee (the "Trustee") for the liquidation of the business of Executive under the 1970 Act.

On June 12, 1975, the Trustee determined that seven institutions which lent securities to Executive and which filed claims in this proceeding were not "customers" of Executive within the meaning of Section 6(c)(2)(A)(ii)² of the 1970 Act, but rather were general creditors of Executive. Four of these lenders, Yale University ("Yale"), Dean Witter Incorporated, the John Hopkins University and Shearson Hayden Stone, Inc. ("Shearson"), opposed the Trustee's determination in the Bankruptcy Court.

1. 15 U.S.C. §78aaa *et seq.*

2. 15 U.S.C. §78fff(c)(2)(A)(ii).

A hearing was held on September 9, 1975, before Judge Galgay, prior to which the parties had submitted memoranda of law to the court. Judge Galgay issued his opinion and order upholding the Trustee's determination on February 23, 1976.

Yale and Shearson (referred to collectively herein as "Claimants") appealed the order to the District Court, which heard oral argument on the question on November 1, 1976, and which affirmed the Bankruptcy Judge's order by an opinion and order dated November 29, 1976. Yale and Shearson seek reversal of that decision by their appeal herein.³ Columbia University has filed an *amicus curiae* brief.

Statement of Facts

Claimants never maintained an account with Executive and never purchased or sold securities through Executive. Instead, they were secured lenders of securities to Executive. The collateral they received was cash equal to 100% of the market value of the securities on the day the securities were lent (Findings 2 and 6).⁴ Yale's loan was pursuant to a written agreement with Executive, called a "Security Loan Agreement"⁵ (Finding 1). Shearson's loan was pursuant to an oral agreement which did not vary in any respect here material from the terms of Yale's agreement (Finding 1).

3. Shearson has joined in the Brief of Claimant-Appellant Yale University (the "Yale brief"); and has filed no separate brief. Because the positions of the two are identical with respect to the issue herein, for simplicity the brief will be referred to as the Yale brief. Likewise, the discussion of the Yale claim should be considered as including the Shearson claim as well, except with respect to the reference to SIPC reimbursement at p. 5 *infra*.

4. Reference to "Findings" are to those contained in Judge Galgay's Opinion, which is reprinted in the Joint Appendix herein, at pp. 4a-9a; the Findings are undisputed.

5. The Yale Security Loan Agreement is reprinted in the Joint Appendix herein, at pp. 21a-26a, as Yale University Exhibit 1.

The value of the transaction to lenders, of course, is to obtain use of the cash collateral, which may be used in any way the lender wishes. The funds received may or may not be invested in the securities market. The funds may, for example, simply be placed in interest bearing bank accounts. In the case of Yale, it is asserted that they were reinvested and used to purchase short-term investments.⁶ This "reinvestment" in no way involved Executive nor, as indicated above, did the original purchase of the loaned securities, which was evidently accomplished through other brokers.

The benefit to the broker from transactions of this sort is that they provide the broker with securities that it needs to meet certain commitments, including, as the District Court noted, the covering of "short" sales by the broker's customers and the fulfilling of its delivery commitments when its customers fail to deliver on time securities which they have sold. 423 F. Supp. at 95 (Joint Appendix, p. 12a).

Each party had the right to "mark to market"; that is, upon twenty-four hours notice, Claimants could demand additional cash collateral in the amount of any increase in value in the loaned securities, and Executive could demand a return of the cash collateral in the amount of any decrease in value in the loaned securities (Finding 3). Yale and Shearson thus had the right to 100 percent collateral on their loans of securities.

The loans could be terminated by either party upon twenty-four hours notice. (Finding 2; Yale Security Loan Agreement, paragraph 3, at pp. 23-24 of the Joint Appendix). Under their agreements, Claimants could treat the loans as terminated in the event that proceedings were commenced by or against the borrower under, *inter alia*, the 1970 Act. (Paragraph 4 of the Yale Security Loan Agree-

6. Yale Brief, p. 7.

ment, at p. 23a of the Joint Appendix). The loaned securities could then be treated as having been purchased by the borrower, and Claimants had the right to obtain collateral equal to the last sales price of the securities prior to the commencement of such proceedings. (Paragraph 4 of the Yale Security Loan Agreement, at p. 23a of the Joint Appendix).

Yale and Shearson have filed claims equal to the money they failed to obtain by marking to market. Yale's claim amounts to \$66,700,⁷ the difference between the \$200,000 collateral it had received from Executive, and \$266,700, the value of the securities it loaned (computed by Yale as of February 14, 1975, the day liquidation proceedings were commenced against Executive). (Finding 2). Shearson's claim amounts to \$38,000. (Finding 2). If Claimants' position is sustained, they will be treated as "customers" of Executive and will be permitted to share in the "single and separate fund,"⁸ and to the extent that the assets of the single and separate fund are insufficient to satisfy these claims, SIPC would be required to advance funds toward the satisfaction of Yale's claim (but would not be permitted to advance funds toward the satisfaction of Shearson's

7. The only issue determined below was Claimants' right to "customer" status. If Claimants were to be accorded "customer" status, the character and amounts of the claims would have to be reviewed by the Trustee. The case would thus be remanded to the Bankruptcy Court for further proceedings. See *SIPC v. Morgan, Kennedy & Co., Inc.*, (Claim of Reading Body Work, Inc.), 533 F.2d 1314 (2d Cir. 1976), cert. denied 426 U.S. 936 (1976).

8. The "single and separate fund" is defined in the 1970 Act as follows:

"(B) SINGLE AND SEPARATE FUND.—All property at any time received, acquired, or held by or for the account of a debtor, or for the account of customers except cash customers, who are able to identify specifically their property in accordance with the prescribed in subparagraph (C), and the property of customers' property transferred by the debtor, and property unlawfully converted, shall constitute a single and separate fund...." 15 U.S.C. §78fff(c)(2)(B).

claim, since it did not arise out of transaction for Shearson's customers).⁹ If the Trustee's position is sustained, Claimants will be treated as other general creditors of Executive.

These loan transactions did not involve securities held in a cash or margin account with Executive for Yale or Shearson; Executive was not expected to hold the securities loaned by Yale or Shearson, but rather was expected to transfer them to third persons (discussed *infra* at 11); the loan transactions did not involve the rendition of any brokerage services by Executive to Yale or Shearson, and Executive realized no commission or other income from Yale or Shearson upon these transactions; in fact, it was Yale and Shearson who provided a service to Executive by lending securities which Executive needed to cover or facilitate its transactions for itself and its regular securities customers, and Executive paid for that service by giving Claimants the use of the cash collateral it delivered to secure the loans.

Opinions of Judge Galgay and Judge Tenney

Judge Galgay held that Claimants' loans are not entitled to the protection given to "customer" claims under the 1970 Act. His opinion relied on the analysis of this Court in *SEC v. F. O. Baroff Co., Inc.*, 497 F.2d 280 (2d Cir. 1974) [hereinafter "*Baroff*"], in which the Court held that a securities lender was not entitled to "customer" protection where the loan was not made in connection with investment or trading activity through the liquidated broker. Judge Galgay indicated that the case for denial of "customer" status is even clearer here than in *Baroff*, since unlike the *Baroff* claimant, Claimants here neither invested nor traded in securities through Executive and had no account with

9. SIPC may not advance more than \$50,000 to satisfy the claim of a given customer. 15 U.S.C. §78fff(f)(1). It may not advance any funds to satisfy claims of broker-dealers unless the claims asserted arose out of transactions for customers of the broker-dealer asserting the claim. 15 U.S.C. §78fff(f)(1)(D).

Executive. He thus affirmed the Trustee's determination that Claimants are general creditors of Executive, and are not entitled to "customer" protection under the 1970 Act.

On appeal, Judge Tenney affirmed the Bankruptcy Court's decision, stating that "a 'customer' is clearly limited to persons who maintained accounts with broker-dealers and who trade or invest through them." 423 F. Supp. at 98. Judge Tenney examined the statutory language, the relevant legislative history and policy arguments, and held that those considerations, as well as those cited by Judge Galgay, reveal that Claimants are not "customers" of Executive within the meaning of the 1970 Act. Judge Tenney examined the *Baroff* opinion and held that the reasons that led this Court to deny "customer" status to the stock lender in *Baroff* militated even more strongly here in favor of denial of customer status to Claimants.

ARGUMENT

A Fair Reading In Context Of Section 6 (c) (2) (A) (ii) And Its Legislative History Demonstrates Beyond Doubt That The District Court Correctly Determined That Yale And Shearson Were Not "Customers" Of Executive. The Order Of The District Court Classifying Them As General Creditors Should Be Affirmed.

I.

Introduction: The Securities Investor Protection Act of 1970.

The 1970 Act was enacted to restore public confidence in broker-dealers by providing specific forms of protection to customers of failed brokerage firms and by upgrading financial requirements for those firms. The United States

Supreme Court recently described the circumstances leading to enactment of the 1970 Act as follows:

"Following a period of great expansion in the 1960's, the securities industry experienced a business contraction that led to the failure or instability of a significant number of brokerage firms. Customers of failed firms found their cash and securities on deposit either dissipated or tied up in lengthy bankruptcy proceedings. In addition to its disastrous effects on customer assets and investor confidence, this situation also threatened a 'domino effect' involving otherwise solvent brokers that had substantial open transactions with firms that failed. Congress enacted the [Securities Investor Protection Act of 1970] to arrest this process, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers. S. Rep. No. 91-1218, pp. 2-4 (1970); H.R. Rep. No. 91-1613, pp. 2-4 (1970)." *SIPC v. Barbour*, 421 U.S. 412, 415 (1975).

The protected class has been understood by every court which has addressed the question to mean those conventional securities customers who entrust cash or securities to their broker in connection with their investment accounts.¹⁰ This Court recognized the limitations on the composition of the protected class in *Baroff* and *Morgan, Kennedy* (discussed *infra*), as well as in the *Packer, Wilbur*

10. See, e.g., *SEC v. Guaranty Bond & Securities Corp.*, 496 F.2d 145, 147 (6th Cir. 1974), *rev'd on other grounds sub. nom. SIPC v. Barbour*, 421 U.S. 412 (1975); *SEC v. Associated Underwriters, Inc.*, 423 F.Supp. 168 (D. Utah 1975); *SEC v. Kelly, Andrew & Bradley, Inc.*, 385 F.Supp. 948, 951 (S.D.N.Y. 1974); *SEC v. Kenneth Bove & Co., Inc.*, 378 F.Supp. 697 (S.D. N.Y. 1974); *SEC v. S.J. Salmon & Co., Inc.*, 375 F.Supp. 867, 871 (S.D.N.Y. 1974); *SEC v. Ridgewood Securities Corp.* (Claim of Benjamin D. Gilbert), Civil No. 72-2053 (S.D. Fla. 1974); *SEC v. Horizon Securities Corp.* (Claim of Charon Styx Associates), Civil No. 72-5112 (S.D.N.Y. May 31, 1974); *SEC v. S.J. Salmon & Co., Inc.* (Claim of Galaxy Fund, Inc.), Civil No. 72-560 (S.D.N.Y. June 13, 1973).

decision, in which the Court stated that the purpose of the 1970 Act "was to extend relief to certain classes of customers" and more particularly to the small investor-customer of the failed broker:

"Legislative attention was focused on the small investor who suffered significant losses when a brokerage house collapsed, often because the house had in its last days misappropriated the investor's funds to its own use. SIPA thus looks to requiring investor-customers of the defunct house. . . ." *SEC v. Packer, Wilbur & Co., Inc.*, 498 F.2d 978, 984 (2d Cir. 1974).

The specific protection that the 1970 Act afforded "customers" of failed broker-dealers was to provide for the Securities Investor Protection Corporation to satisfy their claims up to certain amounts, if assets in the "single and separate fund" were insufficient to pay those claims, and to provide that customers shall receive certain preference over general creditors for claims exceeding the SIPC limits of \$50,000 for claims based on securities and \$20,000 for claims for cash.

The 1970 Act defines the "customers" entitled to receive special protection under the Act as including persons "who have claims on account of securities received, acquired, or held by the debtor from or for the account of such persons . . . (VI) by way of loans of securities by such persons to the debtor. . . ." ¹¹ Appellants argue that since they

11. The full definition of "customer" in Section 6(c)(2)(A)(ii) of the 1970 Act, 15 U.S.C. § 78fff(c)(2)(A)(ii) (which was taken from Section 60e of the Bankruptcy Act), is as follows:

(A) Definitions.—Except as otherwise expressly provided in this section, for purposes of this section and the application of the Bankruptcy Act to a liquidation proceeding—

(i) . . .

(ii) "customers" of a debtor means persons (including persons with whom the debtor deals as principal or agent) who have claims on account of securities received, acquired, or held by the debtor from or for the account of such persons

(footnote cont'd on next page)

made loans of securities to Executive, they come within the statutory definition and are entitled to the special treatment afforded "customers." Appellants' argument does violence to the wording of the statutory definition of "customer," the legislative history of that definition, and this Court's interpretation of both in *Baroff*.

It should be noted that loans such as those made by Claimants have, since their inception, typically been made by substantial institutions, including banks. The Securities and Exchange Commission described the early loans as follows:

"At one time brokers interested in making such arrangements congregated in a so-called 'loan crowd' at a designated place on the floor of the Exchange. Among the principal lenders were large corporations, investment funds, and even banks who were represented by their own brokers. Sometimes the loans were made at premiums providing the lenders with extra income." See Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. II at p. 249 (1963) [hereinafter "SEC Special Study"].

Such transactions are not the sort of transactions between a broker and its customer with which the 1970 Act is concerned. They merely provide grist for the mill which grinds out transactions for the actual securities customers of the borrowing brokers and dealers.

(footnote cont'd from preceding page)

(I) for safekeeping, or (II) with a view to sale, or (III) to cover consummated sales, or (IV) pursuant to purchases, or (V) as collateral security, or (VI) by way of loans of securities by such persons to the debtor, and shall include persons who have claims against the debtor arising out of sales or conversions of such securities, and shall include any person who has deposited cash with the debtor for the purpose of purchasing securities, but shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor; . . ."

Yale acknowledges (Yale Brief, p. 7) that securities loans of the kind here involved are made in order to enable the borrowing brokers to complete securities transactions. Such loans must comply with section 6(h) of Regulation T [12 CFR 220.6(h)] which permits such loans only for the purpose of covering short sales, "fails to receive" and "similar cases" involving "... particular transaction that has already occurred or is in immediate prospect."¹² The borrowing broker-dealer is expected to transfer the loaned securities to third persons and is clearly not holding securities for the account of the lender.

The actual relationship between securities lenders like Yale and the borrowing broker was determined long ago in *Provost v. United States*, 269 U.S. 443 (1926) where it was held that such loans were taxable transfers both at the time of loan and the time of return. The Court thoroughly analyzed the legal consequences of stock loans incident to short sales, among other things, and, *after distinguishing such lenders from a broker's securities customers*,¹³ flatly held:

"But the borrower of stock holds nothing for account of the lender." (269 U.S. at 455)

The Court reasoned, in part:

"For the incidents of ownership, the lender has substituted the personal obligation, wholly contractual, of the borrower to restore him, on demand, to the economic position in which he would have been as owner of the stock, had the loan transaction not been entered into.

12. See Norman F. Swanton Associates [1973-74 Transfer Binder] CCH Sec. L. Rep. ¶79,665 (SEC Div. Inv. Man. Reg. 1973); Interpretations of the Board of Governors of the Federal Reserve System ¶6255 (12 CFR 220.103; 1974 F.R. Bulletin 981).

13. E.g., *Richardson v. Shave*, 209 U.S. 365 (1908); *Gorman v. Littlefield*, 229 U.S. 19 (1913); and *Duel v. Hollins*, 241 U.S. 523 (1916).

When the borrower returns the borrowed stock, he acquires it by purchase or by borrowing again and in the process acquires and transfers to the lender all incidents of legal ownership in securities which neither possessed before." 269 U.S. at 456.

Thus nothing is held, or intended to be held, by the broker for the lender's account.

II.

The *Baroff* Decision Should Govern the Outcome of the Case at Bar.

A. The *Baroff* Decision

This Court held in *Baroff* that the stock lender there was not a "customer" of the liquidated broker-dealer within the meaning of the 1970 Act because the legislative history of the Act and the language used therein indicated that Congress had intended to protect only customers whose dealings with the liquidated broker-dealer had the "indicia of the fiduciary relationship between a broker and his public customer," which the *Baroff* claimant's loan lacked. 497 F.2d at 284.

The facts of the *Baroff* case, as summarized by Judge Tenney, are as follows:

"The claimant in *Baroff*, Mr. Lubin, loaned 7,000 shares of the common stock of Electronic Transistor Corp. to the broker-dealer. The broker-dealer opened an account in Mr. Lubin's name in which the transaction was reflected and issued a receipt to him memorializing delivery. Mr. Lubin authorized the broker-dealer to use the securities as collateral for the broker-dealer's own loans and did not give the securities to the broker-dealer in connection with his own participation in the securities markets. About five weeks after the transaction, proceedings were

commenced for the liquidation of the broker-dealer under SIPA." 423 F. Supp. at 97 (Joint Appendix, p. 16a).

Mr. Lubin contended that he fell within the language of the 1970 Act and was entitled to its protection because he had made a loan of securities, which had been reflected in his account. The court noted that "[i]n the literal sense, that is what happened," but it nonetheless denied "customer" status to Mr. Lubin.¹⁴ 497 F.2d at 282.

After analyzing the legislative history of the 1970 Act, the Court determined that Congress had intended to extend "customer" protection to only those loans made by a customer in connection with trading through the failed broker:

"The legislative history is clear that the 1970 Act was not designed to protect a lender in appellant's class. Most of the definition of 'customers', including subpart VI, was taken from section 60e(1) of the Bankruptcy Act, 11 U.S.C. §96(e) (1), added in 1938, which established special rules '[w]here the bankrupt is a stockbroker.' Both the legislative history of that provision and its use since enactment have stressed protection to, and equality of treatment of, the public customer who has entrusted securities to a broker for some purpose connected with participation in the securities markets. See Comment, *The Bankrupt Stockbroker: Section 60e of the Chandler Act*, 39 Col. L. Rev. 485 (1939); *Tepper v. Chichester*, 285 F.2d 309, 311 (9th Cir. 1960)." 497 F.2d at 282-283.

The Court pointed out that the House Report on the bill stated the bill's "primary" purpose as protection of persons who deal in securities through a broker, when that broker fails:

"The 1970 Act carries through the same theme. The House Report states: 'The primary purpose of

14. In urging a literal reading of the statute and faulting Judge Galgay for an earlier decision of his "conform . . . [ing] to the general policy of the Act" but which did not read the statute literally, Yale (*see e.g.*, Yale Brief, n. 34) necessarily asks that this Court not follow *Baroff*, despite its protestations to the contrary.

the reported bill is to provide protection for *investors* if the broker-dealer with whom they are doing business encounters financial troubles.' H. Rep. No. 91-1613, 91st Cong., 2d Sess., (1970), 3 U.S. Code Congressional and Administrative News, 91st Cong., 2d Sess., 5255 (1970) (emphasis added). Throughout the report 'investors' is used synonymously with 'customers,' indicating that, in the eyes of Congress, the Act would protect capital markets by instilling confidence in securities traders." 497 F.2d at 283.

The Court also noted that the testimony on the bill confirmed that it was the *trading customer* who was to be protected by the 1970 Act:

"Earlier, at the hearings, Chairman Budge of the Securities and Exchange Commission pointed out that 'this is not to be a bailout operation; it is to protect the public customers of the firms * * *' (*Hearings on H. R. 13308 [et al.]* Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 2d Sess., 369 (1970)). Speaking of possible losses of securities by customers, Philip A. Loomis, then SEC General Counsel, now a Commissioner, gave examples showing that it was the trading customer who was to be protected. Similarly a proponent of the measure on the House floor spoke of securities losses by customers of broker-dealers, obviously in the sense of trading customers. 116 Cong. Rec. 39343, 39344 (1970) (Cong. Latta)." *Id.*

The Court then pointed out that events in the securities industry in the late 1960's lent support to the Court's interpretation of Congress' objective in enacting the 1970 Act:

"This Congressional objective is underscored by contemporaneous events in the securities industry. The late 1960's saw the collapse of several brokerage establishments, causing serious financial losses to their clients. Self-help efforts in the industry—such as the New York Stock Exchange Trust Fund—were either severely strained or ineffective. There was

considerable concern that investors, particularly smaller ones would lose confidence in the stability of broker-dealers, and withdraw from the securities market. The President's message endorsing the concept of insurance protection for investors in securities said that such a device 'will assure the investor that the stability of the securities industry itself does not become cause for concern' (House Hearings, *supra*, at 345). *The emphasis throughout was on the customer as investor and trader, not on others who might become creditors of the broker-dealer for independent reasons.*" *Id.* (Footnote omitted; emphasis supplied.)

The court noted that "[t]here was no actual or likely use of the shares as collateral for margin purposes by Lubin of other securities. . . . [T]here was no reasonable expectation that the shares would be sold for Lubin's account in the near future. . . ." The court then concluded that the Lubin loan did not have "the indicia of the fiduciary relationship between a broker and his public customer, but rather [had] the characteristics of, at most, an ordinary debtor-creditor relationship."¹⁵ 497 F.2d at 284.¹⁶

Accordingly, the court held that

"Because [Mr. Lubin's] loan to the broker-debtor *had no connection with his trading activity in the securities market*, he cannot qualify by virtue

15. Yale conceded in its Memorandum before the Bankruptcy Judge that it did not rely on Executive for protection, and in that statement revealed the lack of fiduciary relationship between it and Executive:

"Yale did not rely on the ability of Executive as a business enterprise to repay the loan, but rather required Executive to mark to market in order to protect Yale's investment in the loaned securities." (Yale's Memorandum before Bankruptcy Judge, p. 26.)

16. As recognized by Judge Tenney, this Court again addressed the meaning of the word "customer" as used in the 1970 Act in *SIPC v. Morgan, Kennedy & Co., Inc.* (Claim of Reading Body Works, Inc.), 533 F.2d 1314 (2d Cir. 1976), *cert. denied* 426 U.S. (footnote cont'd on next page)

thereof as a 'customer' entitled to the benefits of the Securities Investor Protection Act." 497 F.2d at 284 (emphasis added).¹⁷

In analyzing the word "customer" in this manner, this court followed long established principles of statutory construction:

"[T]here is wisely no rule of law forbidding resort to explanatory legislative history no matter how 'clear the words may appear on superficial examination.'" *Harrison v. Northern Trust Co.*, 317 U.S. 476,

(footnote cont'd from preceding page)

936 (1976), and reaffirmed that "customers" are limited to those who trade or invest in securities through the liquidated broker-dealer:

"[In *Morgan, Kennedy*] the court reviewed its decision in *Baroff* and, noting at page 1317 that '[e]mphasis on the customer as investor and purchaser/trader has been a consistent theme in cases in this Circuit,' held that in spite of the fact that the Reading Body Works, Inc. Trust was a customer of Morgan, Kennedy & Co., Inc. the individual beneficiaries of the Trust were not customers of Morgan, Kennedy (and thus were not each entitled to the maximum reimbursement from the SIPC Fund). Although the *Morgan, Kennedy* opinion does not bear directly on the status of a stock lender, it reaffirms the meaning of "customer" as one who trades or invests in securities through the failed broker-dealer." 423 F. Supp. at 97, n. 1 (Joint Appendix, pp. 19a-20a, n. 1).

As recognized by Judge Tenney, decisions concerning different aspects of the 1970 Act have also recognized that the Act was designed to protect customers who traded through the failing broker. *SEC v. Packer, Wilbur & Co., Inc.*, 498 F.2d 978 (2d Cir. 1974); *SEC v. Aberdeen Securities Co., Inc.*, 480 F.2d 1121 (3d Cir. 1973). *Cert. denied* 414 U.S. 1111 (1973). *Id.*

17. Columbia University ("Columbia") urges in its *amicus curiae* brief that the distinction between lenders who maintain trading accounts with the borrower and those who do not is "without substance and arbitrarily restricts lending of securities regardless of mutual need or desire," because customers who trade through a particular broker may not have left the securities needed by the broker in trading accounts with that broker. Columbia Brief, p. 11. Columbia is simply wrong in claiming that its interpretation is consistent with *Baroff*; its conclusion can be reached only by reading out of the *Baroff* decision the requirement quoted above, that the loan be connected to the lender's trading activity.

479 (1943).¹⁸ "The rule that, where the statute contains no ambiguity, it must be taken literally and given effect according to its language . . ." has utility only where it effectuates the intent of Congress. *Helvering v. New York Trust Co.*, 292 U.S. 455, 464-465 (1934). A literal interpretation of words read in isolation is inappropriate, even where "such an interpretation is possible." *NLRB v. Lion Oil Co.*, 352 U.S. 282, 288 (1957); *Mastro Plastics Corp. v. NLRB*, 350 U.S. 270, 285 (1956). A construction at variance with the statutory purposes "is to be avoided unless the words Congress has chosen clearly compel it" *NLRB v. Lion Oil Co.*, *supra*.

B. Application of *Baroff* to this Case

Yale offers three grounds for distinguishing the *Baroff* case, none of which has merit. First, it argues that its agreement with Executive "expressly required the securities to be used to satisfy Executive's obligations for delivery of securities as a part of Executive's business of trading securities in the securities market." Yale brief, p. 27. This argument misses the point. The securities undoubtedly were used in connection with Executive's securities business, just as Executive may have used a bank loan of cash in its securities business. But that does not render a bank or a secured lender a "customer" of Executive. The importance of stock loans to the delivery mechanism of the securities industry hardly distinguishes Yale from the spectrum of other suppliers of goods and services, including banks, without which brokers could not function.

Second, Yale distinguishes *Baroff* on the ground that Yale's loans were related to its investment in the securities market, because it received collateral in return for its loans.

18. See also, *United States v. American Trucking Ass'ns*, 310 U.S. 534, 543-544 (1940); *United States v. Dickerson*, 310 U.S. 554, 561-562 (1940); *Boston Sand & Gravel Co. v. United States*, 278 U.S. 41, 48 (1928).

whereas the lender in *Baroff* received no consideration for his loan and was helping the broker-dealer through financial difficulties. But, as Judge Tenney stated, the receipt of money in connection with the securities loan does not furnish the required connection between the loan and trading activity:

"... the mere receipt of money in return for the use of securities does not provide the requisite connection between the loan of securities and trading activity. Claimants purchased securities elsewhere before loaning them to Executive; their claims fail, *not* because they are not *investors* in the securities market, but because their securities were not lent in connection with trading or investment through Executive." 423 F. Supp. at 98 (Joint Appendix, p. 17a).

Yale's third ground for distinguishing the *Baroff* case is that having received cash collateral in return for the loan of securities, Yale invested the proceeds "as part of its total investment program." Yale brief, p. 27. But Yale did not invest the proceeds through Executive, as Executive's "customer," and Yale's subsequent investment through other broker-dealers (or other entities, such as banks) does not entitle it to status as Executive's customer. Indeed, nothing could be clearer than that prior to the commencement of this liquidation, Yale would never have considered calling a firm like Executive one of *its* brokers, nor did Executive enjoy the prestige of calling Yale its "customer."

Yale has failed to come to grips with the *Baroff* holding that not all lenders of securities are "customers" and that it is only those who looked to the broker for protection, and had a "fiduciary" relationship with him, who are "customers". Yale has advanced no sound basis for its inclusion as a "customer" under the principles enunciated in *Baroff*. Those principles prevent Claimants, as collateralized lenders pursuant to a Security Loan Agreement who neither traded nor invested in securities through Executive,

from being deemed "customers" within the meaning of the 1970 Act.¹⁹

III.

The 1970 Act's Definition of "Customers" Does Not Include Claimants.

Claimants suggest that their transactions fall "squarely within the transactions listed in Section 6(c) (2) (A) (ii) of the 1970 Act" and urge that the Act be applied literally. Yale Brief, p. 11. Even if the Act were to be read literally (despite *Baroff*), Claimants would not come within its definition of "customer."

On page 9 of Yale's brief, Yale advised this Court that the "relevant portion of the 1970 Act's definition of "customer" is:

"'customers' of a debtor means persons . . . who have claims on account of securities received . . . by the debtor from . . . such persons . . . *by the way of loans of securities by such persons to the debtor . . .*"
(Emphasis supplied by Yale.)

19. Yale states, at p. 14 of its Brief, that SIPC proposed legislation to amend the definition of "customers" by deleting any reference to loans of securities. As the section by section explanation on the proposed legislation states, the subsection (VI) reference to lenders in the definition of "customers" would have been dropped "since it has been used by some lenders in an attempt to gain for themselves the preferred position of customers." Hearings on H. R. 8064 [Securities Investor Protection Act Amendments of 1975] Before Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st Sess. 87 (1975). In short, it was intended to avoid spurious claims of the kind involved here and in *Baroff*. The amendment would not have affected the rights of cash and margin customers who lend securities from their trading accounts to their broker and do not receive consideration for their loans. *Id.*

Yale omits therefrom certain key words, specifically the Act's reference to the customer's "account."²⁰ Thus, the definition in the 1970 Act actually reads:

"'customers' of a debtor means persons . . . who have claims on account of securities received by the debtor from *or for the account of* such persons . . . by way of loans of securities by such persons to the debtor" (Emphasis supplied.)

As this Court held in *Baroff*, it is only people who maintain accounts with a broker-dealer and who trade or invest through them that Congress sought to protect in the 1970 Act. As recognize by Judge Tenney, Claimants had no account with Executive and clearly do not come within the Act's definition of the word "customer."

Claimants do not come within the 1970 Act's definition of "customer" for a second reason. The mention of loans of securities in subsection (VI) of the definition of "customers" is specifically qualified by the phrase "by such persons." Since the previous types of transactions listed—“(I) for safekeeping, or (II) with a view to sale, or (III) to cover consummated sales, or (IV) pursuant to purchases, or (V) as collateral security”—all refer to the normal customer transactions with brokerage houses, it seems logical that it was thought necessary to include the “by such persons” qualification in the reference to securities loans to emphasize that only securities loans by persons having the usual customer-transactional relationship with the brokerage house were to be accorded such special protection.

20. As Yale notes in its Brief at page 33, n. 11:

“‘. . . it is a cardinal rule of statutory construction that significance and effect should, if possible, without destroying the sense or effect of the law, be accorded every part of the act, including every section, paragraph, sentence or clause, phrase, and word.’ 73 Am. Jur. 2d, Statutes, § 250 (1974) (footnotes omitted). See also 82 C.J.S. Statutes § 243 (1953).”

Yale's attempt at page 12 of its brief to explain inclusion of the words "by such persons," as a requirement that the loans be made by the person making the claim, cannot be supported; because the definition begins with the words "customers' of a debtor means persons . . . who have claims," Yale's interpretation would render the phrase "by such persons" in subparagraph (VI) an unnecessary redundancy and thus meaningless, violating accepted principles of statutory construction.

As Yale aptly points out, the use of the introductory word "means" rather than "includes" ("customers' of a debtor means persons . . ."), makes the definition of "customers" an *exclusive* definition. Yale Brief, p. 10. The word "means" restricts the compass of the term to persons with claims based on the enumerated types of transactions. This lends further support to an interpretation of the word "customer" as including only those who fall within the strict terms of the statutory definition, which, as shown above, would exclude Claimants.

The foregoing interpretation of the statutory language recognizes that conventional trading customers may and do authorize their broker to borrow securities from their accounts. Such borrowings are merely incidental to the principal trading purpose of a regular securities account.²¹ They differ substantially in their terms and legal effect from fully collateralized institutional loans of the kind here in issue.²² The borrowing of securities from customers' accounts is regulated by Section 8(e) of the Securities Exchange Act of 1934 as amended [15 U.S.C. § 78h(e)] as well

21. See 1 Meyer, *The Law of Stockbrokers and Stock Exchanges*, §§ 76-77, at 356-8 (1931) [hereinafter "Meyer"].

22. SEC Special Study at 176, 248-9; see also, *Stock Exchange Practices*, Report of Comm. on Banking & Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. 50-51 (1934); Meyer, § 29, at 186-88; 1 Black, *The Law of Stock Exchanges, Stockbrokers and Customers* § 5, at 4 (1940) [hereinafter "Black"]; Petrillo & Bullock, *Processing Securities Transactions* at 78-79, 121-22 (1969).

as the rules of the various self-regulatory organizations.²³ That such loans from customers' accounts were contemplated by the 1970 Act is evident from portions of its legislative history, including the portion immediately preceding the testimony cited by this Court in *Baroff* (497 F.2d at 283) in support of its statement that the 1970 Act contemplated the protection of the "trading customer".²⁴

Yale is correct insofar as it states, at page 22 of its brief, that the interpretation of Appellees and the courts below requires that in order for a claim arising out of a loan of securities to be deemed a "customer" claim, the securities must have been loaned from a regular account with the broker-dealer being liquidated. We believe, for all of the reasons set forth herein, that this conclusion is inescapable. Yale is incorrect, however, in asserting that Appellees or the courts below require that the loaned securities have been purchased from or through the broker to whom they are loaned.

If (1) Yale had an account with Executive through which it traded in securities, (2) Yale placed securities in that account for trading or safekeeping purposes (even if purchased through another broker or received as a donation), and (3) Executive borrowed those securities in accordance with Section 8(c) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78(c)), Yale's loan would be no different from the ordinary customer loan of securities and a claim based on loss of those securities would be entitled to

23. NASD Rules of Fair Practice Art. III §§ 19(b) and (c); CBOE Rule 9.16; PBW Rule 742; Pacific Rule X, § 7; Midwest Art. XVII, Rule 18; Amex. Rule 412; NYSE Rule 402; Boston, Rules of the Board of Governors, Ch. VII, § 3.

24. Hearings on H.R. 13308, H.R. 17585, H.R. 18081, H.R. 18109, H.R. 18458 Before the Subcom. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong. 227 (1970): "There are some provisions in the statute governing the hypothecation and lending of customers' securities." (Statement of Mr. Pollack, Director, SEC Division of Trading and Markets.) See also, 116 Cong. Rec. 40,901 (1970) (amendment of Sen. Brooke).

be treated as a "customer" claim. Yale had no such account with Executive and did not leave securities in the account for safekeeping or trading purposes. Rather, it loaned them directly to Executive pursuant to the Security Loan Agreement.

Yale's Brief attempts to show that "Yale fits perfectly into clause (VI) of the definition" in section 78fff(c)(2)(A) (ii) of SIPA (Yale Brief at 12) (emphasis added). This shoehorn approach, which ignores substance and the realities of its relationship to Executive²⁵ (discussed *infra* at [3-7]), represents the inherent vice in Yale's position. To be sure, appropriate attention and effect must be given to the words in the definition of "customer." But the so-called "transactional" test urged by Yale constitutes the sort of arid semantics proscribed by this Court in *Baroff* (at 282) where it cautioned against being "... caught in the trap of language which seems, literally, too broad or too narrow to accommodate the patent legislative purposes."

IV.

The Legislative History

This Court's discussion of the legislative history of the 1970 Act in *Baroff* demonstrates conclusively that Congress did not intend to extend customer protection to securities lenders such as Claimants.

That intent is even more manifest in light of the legislative history of Section 60e of the Bankruptcy Act, 11 U.S.C. § 96(e), from which, as Yale's brief concedes (Yale Brief, p. 14), the definition of "customer" in the 1970 Act was derived verbatim in the respects material here. As Judge

25. See *SIPC v. Morgan, Kennedy & Co., Inc.*, 533 F.2d at 1318. In anyone's language, a customer is one who purchases goods or services for a charge imposed by the vendor. What sense could it make to call one a customer who has purchased and paid for nothing? Yet that is the position taken by Yale and Shearson.

Tenney recognized, nothing in the legislative history of Section 60e suggest that Congress intended to do anything more than remedy the unequal treatment of cash and margin customers in certain jurisdictions, and to protect customers who made loans of securities out of their trading accounts in connection with their participation in the securities markets. 423 F. Supp. at 98.

Prior to enactment of Section 60e, the common law of the several states largely determined the rights of margin and cash customers in stockbroker bankruptcy proceedings. Both types of customers were relegated to the status of general creditors if they could not trace their securities under contemporary tracing doctrines. The rights of margin customers varied depending upon the jurisdiction; most jurisdictions treated them as pledgors of the margin securities with a right to trace (New York Rule), while some treated them solely as general creditors (Massachusetts Rule). In the final analysis, various principles were applied by the courts, which made the rights of margin and cash customers depend largely upon fortuitous circumstances.

It is clear that the overriding concern of Congress in enacting Section 60e was to correct the inferior status of margin customers. This is evident from the statutory history of 60e, and has consistently been so understood by commentators²⁶ and the courts.²⁷ The House of Representatives Report on the bill that, with amendments, became the Bankruptcy Act of 1938 contains one page of discussion of the purpose behind Section 60e, all of which discussion

26. J. Weinstein, *The Bankruptcy Law of 1938*, 122-125 (1938) [hereinafter "Weinstein"]; Gilchrist, *Stockbrokers' Bankruptcies: Problems Created By the Chandler Act*, 24 Minn. L. Rev. 52 (1939) [hereinafter "Gilchrist"]; Comment, *The Bankrupt Stockbroker: Section 60e of the Chandler Act*, 39, Colum. L. Rev. 485 (1939).

27. *Sec. e.q., SEC v. First Sec. Co.* 366 F. Supp. 367, 371 (N.D. Ill. 1973), modified, 507 F.2d 417 (7th Cir. 1974); *Tepper v. Chichester*, 285 F.2d 309, 311 (9th Cir. 1960); *In Re McMillan, Rapp & Co.*, 123 F.2d 428 (3d Cir. 1941).

relates only to the situation of the margin customers.²⁸ One commentator, Jacob Weinstein, noted that the enactment of Section 60e stemmed from a concern over "serious inequities in distribution . . . among margin customers and between margin and cash customers," and went on to state:

"This new subdivision is intended to make the law uniform and to avoid inequalities in distribution. *Upon the bankruptcy of a stockbroker, all margin and cash customers are treated as a single class and the securities and proceeds on hand for the purchase or from the sale of the securities of such customers are set up into a single and separate fund, to be distributed, except as otherwise provided in this subdivision, pro rata among such margin and cash customers, according to their respective net equities in their trading accounts.*" J. Weinstein, *The Bankruptcy Law of 1938*, 122 (1938). (Emphasis supplied.)

There is nothing in the legislative history of Section 60e or the cases under it that suggests that Congress thereby intended to do more than solve the problem before it, which was to eliminate the inequities among cash and margin customers, and, in connection therewith, to provide protection to cash or margin customers who made loans of securities to brokers in connection with their participation in the securities markets and out of their trading accounts.²⁹

Yale's so-called "transactional" approach, which ignores the substance of the relationship between the parties

28. *Revision of the National Bankruptcy Act*, H.R. Rep. No. 1409, 75 Cong., 1st Sess. 31 (1937). See also, Gilchrist at 57 n. 29, where the author states that the drafters of section 60e "gave no deep consideration to the rights of the customer who did not enter into margin transactions."

29. See §8(c) of the Securities Exchange Act of 1934, as amended, and the rules governing loans of customers' securities promulgated by various self-regulatory organizations, cited at p. 22, n. 23 *supra*. See also, NYSE Rules 501 and 502, published in Black, 880 (1940). These rules were adopted on May 16, 1938, a month before the Chandler Act was enacted. *Id.* at 839.

deemed controlling in *Baroff*, may have been inspired by the following statement of Jacob I. Weinstein on which Yale's brief relies (Yale Brief, p. 18): "This is a comprehensive definition designed to cover every form of transaction dealt with under this subdivision."³⁰ Regarding this statement (and others) Mr. Weinstein acknowledged:

"These comments and the comments which follow under this subdivision e are derived from an excellent note prepared by Harry Zalkin, Esq., a member of the New York Bar, for the House Committee Print (H.R. 12889, 74th Congress, 2d Session, May 28, 1936)."³¹

The note referred to by Mr. Weinstein is a commentary prepared by Mr. Zalkin for the National Bankruptcy Conference, which conference developed the Chandler Act, of which Section 60e was a part. That note makes it clear that the definition of "customers" was intended to include only *cash* and *margin* customers."³²

30. Weinstein, at 123.

31. *Id.* at 122.

32. Mr. Zalkin was a member of the National Bankruptcy Conference. The Conference's first published draft of section 60e defined "margin customer" and "cash customer" (rather than "customer"), as did several subsequent bills. National Bankruptcy Conference, House Judiciary Comm., 74th Cong., 1st Sess. 156-59 (Comm. Print 1935) [hereinafter "Comm. Print—1935"]; H.R. 10382, 74th Cong., 2d Sess. (1936); H.R. 12889, 74th Cong., 2d Sess. (1936); H.R. 6439, 75th Cong., 1st Sess. (1937). The commentary appended thereto was prepared by Mr. Zalkin. Comm. Print—1935, at 158-59. The entire legislative discussion related to margin and cash customers. The definition of customer in section 60e as finally enacted first appeared in a bill introduced by Congressman Chandler on July 28, 1937. Significantly, the accompanying House Report (H.R. Rep. No. 1409, 75th Cong., 1st Sess. (1937)) not only did not suggest that the customer definition was meant to include persons other than cash and margin customers, but it affirmatively demonstrated the contrary. Thus, it specifically employed Mr. Zalkin's aforesaid commentary (*id.* at 31) which was the conceptual basis at all times underlying the legislative purpose in enacting section 60e.

Yale cites no authority which actually supports its position that lenders like itself were customers under section 60e. The few pre-section 60e citations it does proffer are totally irrelevant and unhelpful to Yale (Yale Brief, p. 7, n.3; p. 16, n.17; and p. 26). See, *In re Archer, Harvey & Co.*, 289 F. 267 (D. Md. 1923); *In re T. A. McIntyre & Co.*, 181 F.955 (2d Cir. 1910); Oppenheimer, *Rights and Obligations of Customers in Stockbrokerage Bankruptcies*, 37 *Harv. L. Rev.* 860, 861 (1924). *Archer* and *McIntyre* are reclamation cases which did not deal with collateralized securities lenders. The *McIntyre* facts are substantially those in *Baroff*, *supra*. In *Archer*, Mrs. Ricker, a non-customer borrowed money from the broker to finance her son's education, and as security left some stocks with the broker. The *Archer* facts appear to be the predicate for the hypothetical "Osmo" loan referred to by Yale in Mr. Oppenheimer's article. Yale is incorrect in stating (Yale Brief, p. 26) that Mrs. Ricker in the *Archer* case was "treated as a customer." Yale seems to forget that reclamation rights in bankruptcy were not, and are not, limited to customers of brokers.

There is nothing in the legislative history discussed above to suggest that Congress was concerned with broadening the protection that parties to secured loan agreements such as Claimants would receive. In short, rather than advancing Yale's contention, the legislative history of Section 60e and the cases considering it support the Trustee's contention and the holding of the lower courts that Congress never intended to afford special protection to persons in Claimants' position.

V.

Policy Considerations Against According Customer Status to Claimants.

Yale mentions purported policy considerations,³³ at pp. 21-23 of its Brief, in support of its position, but the facts of this case and of the industry demonstrate that policy considerations militate *against* according Claimants here "customer" status with preference over other creditors. Yale's loan was fully collateralized at the outset and Yale had the right to mark to market daily to keep the loan fully collateralized. It thus did not have to rely upon the solvency of the broker for protection, but rather could rely upon its contractual right to full collateral.³⁴ As Judge Tenney pointed out, Yale thus has ample means under its agreement to protect itself,³⁵ and in that respect differs

33. Yale argues that (1) the distinction between itself and customers is artificial, (2) Congress intended all stock lenders to be customers, and (3) denying lenders such as Yale "customer" status could discourage securities loans, and thus increase the incidence of fails to deliver. Yale Brief, p. 22.

34. Yale and Columbia have distorted this point, which was relied upon by the Bankruptcy Judge and the District Court, and claim that it is tantamount to making diligence a prerequisite to "customer" status. See Yale brief at p. 29, Columbia brief at pp. 18-19. There is, of course, no such requirement. The point is that Yale and other such lenders are protected by their contractual right to "mark to market," which, if diligently exercised, fully protects them; thus they do not need the special protection devised by Congress.

35. Yale is correct in assuming that any similarly situated lender with a security loan agreement that provides for 100 percent collateral—even the blue collar worker hypothesized by Yale at p. 23 of its brief—would be denied "customer" protection by the Trustee's and the lower courts' interpretation of the definition of "customer." As indicated in the discussion of the legislative history at pp. 28-34 herein, there is nothing to indicate that Congress intended to give "customer" protection to secured lenders such as these. It should be noted, though, as Columbia recognizes at page 3 of its brief, that secured loans of the sort under consideration here are typically made by broker or institutions, not by blue collar workers from New Haven.

significantly from the customers who were the subject of the Congressional concern that lay behind the 1970 Act:

"Nor are there persuasive policy reasons to give special protection to securities lenders such as claimants. Indeed, they already enjoy greater protection than normal secured creditors, not only because their collateral is fully liquid cash, but also because of their right to demand additional cash collateral in the case of market increases." 423 F.Supp. at 98-99.

Affirmance of the Trustee's determination in this case thus would not undermine investor confidence. On the contrary, it would have the positive result of encouraging future institutional lenders of securities to watch the day-to-day value of their collateral more diligently .

Conclusion

As recognized in the *Baroff* decision, the 1970 Act was not intended to provide a "bailout" for all creditors of insolvent brokerage firms. Its protection was limited to investors and traders who wished to participate in the securities markets and who might fear to do so if they would be wiped out if their broker failed. Congress did not (nor did it intend to) protect secured lenders, such as Claimants. Claimants are not "customers" within the meaning of the 1970 Act and the decision of the District Court should be affirmed.

Respectfully submitted,

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